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DEPARTMENT FOR EUR DAS GARBER AND EUR/CE

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SUBJECT: SCENE-SETTER FOR THE VISIT OF DAS JUDY GARBER

¶1. (SBU) Over the past four months, the GoH has been reacting to a series of crises that have gripped the nation's attention, beginning with the financial market crisis in October, followed by an ongoing diplomatic row with Slovakia, transportation sector strikes in December, and now the growing crisis over the supply of gas from Russia.

¶2. (SBU) Governing without a Parliamentary majority and consistently trailing well behind FIDESZ in public opinion polls, Prime Minister Gyurcsany's government has worked hard to present itself as managing crises that they did not create. But they have yet to make good on their promise to "return to reform" in order to address the structural issues necessary to promote growth and to prevent a protracted economic downturn. Although contacts increasingly believe that the government will remain in place at least for the near term, they expect few dramatic steps - particularly with the 2009 European Parliamentary elections approaching.

¶3. (SBU) On the economic front, the international stabilization package appears to have staved off the immediate crisis, and has helped stabilize the bond and currency markets. In recent weeks the government securities market has shown gradual signs of recovery, as domestic demand for government bonds and demand at auctions is increasing, although senior officials admit, "there is no appetite for Hungarian paper." On the other hand, use of the IMF and EU lines of credit to meet part of the government's financing needs has allowed Hungary to reduce its level of new issuances, reducing supply pressure in the bond market. Non-resident bond holders remain net sellers, and it is unclear when foreign investors will have the confidence to return to Hungary's financial markets or when there will be sufficient demand for government securities to increase the level of new issuances to pre-crisis levels. Similarly, a rapidly dropping inflation rate and greater stability of the forint has allowed the Hungarian Central Bank to slowly begin to roll back its October emergency 300 basis point interest rate increase.

¶4. (SBU) The country is bracing itself for a difficult road ahead, however, as the Government imposes expenditure cuts in order to meet commitments made to the IMF to accelerate its deficit reduction program. News from the fourth quarter of 2008 is overwhelmingly negative, including record lows in savings and consumer confidence, and a steep drop in industrial production. The impact of the global economic slowdown is likely to increase as layoffs and company shutdowns increase.

¶5. (SBU) The first formal IMF review of Hungary's performance in implementing its loan commitments is scheduled for February. Although it appears to be on track to meet its deficit reduction targets, pressure from public sector workers' unions has already caused the Government to dip into budget reserves and roll-back some of its planned austerity measures affecting workers in the enormous public sector. There is also a risk that a worsening of the economic

situation could make 2009 deficit reduction targets more difficult to meet - particularly given the temptation to increase spending in an election year.

¶16. (SBU) Looking ahead, initial estimates of a 1 percent contraction in the economy for 2009 are now considered optimistic, as some analysts now suggest the figure will likely be closer to 3 percent. The IMF predicts that Hungary will not achieve its potential growth rate of 3 percent until ¶2011. Senior officials admit that Hungary's growth is "at the mercy of the fortunes of Western Europe", given the economic importance of exports to Germany, Italy, and other Western European countries, and the fact that Hungary's current macroeconomic situation makes it impossible to use fiscal policy for economic stimulus.

¶17. (SBU) Economists and the international business community continue to call for structural economic reform in order for Hungary to remain competitive and achieve higher levels of economic growth. Prime Minister Gyurcsany has recently renewed his calls for reform in local government administration, taxation and pensions. But both the public's willingness to accept difficult reforms and the Government's ability to enact them remain open questions. As this vicious circle of weak leadership and partisan gridlock persists, so does the risk of public susceptibility to the message of increasingly visible, vocal, and violent extremists.

¶18. (SBU) You are scheduled to take part in the joint State and Defense Department European anti-corruption conference, and are scheduled to open the conference with Justice and Law Enforcement Minister Tibor Draskovics, although he may cancel due to a newly-scheduled cabinet meeting. A close and long-time confidant of the Prime Minister, Minister Draskovics has served in a variety of Ministerial capacities. Now presiding over law enforcement as well as legal issues, he is a key player on transparency, tolerance, and border security.

¶19. (SBU) Your meeting with MFA State Secretary Laszlo Varkonyi is an opportunity to cover the waterfront. Varkonyi is an experienced diplomat whose portfolio includes the U.S. (and most of the world outside of Europe). He'll welcome the latest news from Washington, and may be able to update us on the GoH's views regarding recent Portuguese efforts to promote EU engagement on Guantanamo detainees. You might also use this opportunity to update the MFA on the lack of progress in concluding a new bilateral tax treaty, and given its importance to the bilateral relationship, seek greater MFA engagement on the issue.

¶110. (SBU) You are also scheduled to meet with professor and political commentator Tamas Magyarics. Since your last meeting with Magyarics, he has been named Deputy Director of the International Center for Democratic Transition. An excellent embassy contact, Magyarics can offer his perspective on the full range of foreign and domestic issues, including intolerance and extremism.

¶111. (SBU) For a perspective on the state of the Hungarian economy, we have scheduled a meeting with Kristian Orban and Tamas Vojnits, two impressive young economists with a great grasp of Hungary's myriad problems. Together they run Oriens, a locally owned M&A advisory and private equity fund management firm, and they authored a study in 2007 on economic reform in Hungary. Though associated with the opposition, Orban was called in to advise the GoH in formulating the stabilization package. Not only can they provide a good perspective on what reforms Hungary needs, but also have a good sense of the political climate for reform.

¶112. (SBU) Finally, you are scheduled to meet with members of the Prime Minister's Foreign Policy Advisory Board. Led by international legal scholar Laszlo Valki, the Board provides informal advice to the PM and has served as a useful parallel channel on the full range of bilateral issues.

¶113. (SBU) We look forward to welcoming you in person.

